

# City of Detroit

## CITY COUNCIL

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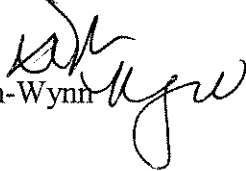

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**TO:** The Honorable Detroit City Council

**FROM:** David Whitaker   
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**DATE:** June 9, 2006

**RE: LOOK-BACK ADJUSTMENT**

This memorandum is the Research and Analysis Division's (RAD's) response to this Honorable Body's concerns regarding the Detroit Water and Sewerage Department's (DWSD) look-back sewage adjustment for Detroit customers.

### **BACKGROUND**

Generally speaking, the Water and Sewerage Department sets rates prospectively, i.e., the Department projects or estimates the amount of funds it will need to operate during the upcoming year. At the end of the year, the projected costs and revenues must be reconciled against the actual costs and revenues. Ideally, revenues and expenses are reconciled in sufficient time so any adjustments (deficit or surplus) would coincide with the implementation of the rates for the next year.

In this instance, this Honorable Body approved the water and sewerage rates in March 2006. However, DWSD has advised that a recent audit report revealed a shortfall that requires a look-back adjustment for fiscal year FY 2004-05 for users in the City of Detroit.

### **ANALYSIS**

In a memo dated May 30, 2006 to the Deputy Fiscal Analyst, the Director of DWSD stated that the primary cause of the look-back adjustment for sewage rates is due to the collection rate of bills issued to City of Detroit customers:

.... As part of the independent audit of the Sewage Disposal System, over \$30 million of unanticipated bad debt expense was booked. The City's Rate Settlement

Agreements with its suburban customers requires that this amount be recovered solely from City of Detroit customers, and this \$30 million + variance makes up the majority of the City of Detroit Look-Back. Additional contributing factors include the fact that billed sales to City of Detroit customers were over 20% below targeted levels during FY 2004-05, and there are certain other "Detroit only" fixed costs that must be recovered over this smaller base. The bottom line is that there are certain revenue requirements that must be collected from City of Detroit customers.

RAD received a copy of the 1980 Rate Settlement Agreement from the Law Department. The portion of the Agreement that pertains to the look-back adjustment is articulated in Paragraph 4 on page 12:

4. Credit Requirement Applicable to Revenue Surpluses and Deficits

(a) Beginning with the period ending June 30, 1981, to the extent required by 40 CFR 35.929-2(b) (3), DWSD shall review the waste-water contributions of, and all costs attributable to, the user classes and subclasses set forth in paragraph 4.(b) hereof for the purpose of determining and applying revenue surpluses or deficits allocable to said user classes and subclasses.

(b) For the purposes of paragraph 4. (a) hereof, user classes for the period through June 30 1981, shall be deemed to include:

- (i) Users located in the City of Detroit;
- (ii) Metered Suburban customers of DWSD;
- (iii) Unmetered Suburban customers of DWSD;
- (iv) Clinton-Oakland Sanitary District;
- (v) Macomb Sanitary District;
- (vi) Users subject to surcharges for BOD, TSS, P or FOC; and
- (vii) Users subject to a stormwater charge.

Simply put, DWSD is required to review the waste-water contributions of, and all costs attributable to, the user classes and subclasses for the purpose of determining and applying revenue surpluses or deficits to be allocated those respective classes. That review must be done in accordance with requirements set forth in the Code of Federal Regulation. The Code requires that the charges generate sufficient revenue to pay the total operation and maintenance costs necessary to the proper operation and maintenance (including replacement) of the treatment works. In the event there is a surplus, the excess

revenues collected from a class of users for the costs of operation and maintenance must be applied to that class for the next year, i.e., the rates must be adjusted accordingly.

40 CFR 35.929-2 is cited below in pertinent part:

§ 35.929-2 General requirements for all user charge systems.

User charge systems based on actual use under § 35.929-1(a) or ad valorem taxes under § 35.929-1(b) shall also meet the following requirements:

(a) Initial basis for operation and maintenance charges. For the first year of operation, operation and maintenance charges shall be based upon past experience for existing treatment works or some other method that can be demonstrated to be appropriate to the level and type of services provided.

**(b) Biennial review of operation and maintenance charges. The grantee shall review not less often than every 2 years the waste water contribution of users and user classes, the total costs of operation and maintenance of the treatment works, and its approved user charge system. The grantee shall revise the charges for users or user classes to accomplish the following:**

(1) Maintain the proportionate distribution of operation and maintenance costs among users and user classes as required herein;

**(2) Generate sufficient revenue to pay the total operation and maintenance costs necessary to the proper operation and maintenance (including replacement) of the treatment works; and**

**(3) Apply excess revenues collected from a class of users to the costs of operation and maintenance attributable to that class for the next year and adjust the rate accordingly (Emphasis added).**

It is unclear whether the look-back adjustment for sewage rates that has been identified must be applied solely to the rates for the upcoming fiscal year. In a memo dated June 5, 2006 to the Deputy Fiscal Analyst, the Director of DWSD provided the

following response:

Question No. 3: If the bad debt covers more than one year, why make the bad debt adjustment all in one year? In other words, could the \$30 million hit be spread over a few years, like three years?

Response: DWSD made just such a proposal to the independent auditors. Unfortunately, Generally Accepted Accounting Principles require for the entire amount to be reflected at the time it can be estimated. **The auditors have insisted that all of the adjustment be taken in FY 2004-05<sup>1</sup>. (Emphasis added).**

While the Code provisions cited above indicate that the rates must be revised to ensure that sufficient revenue is being generated, there is no specific reference to a time period during which any deficit must be applied.

### **CONCLUSION**

When determining and applying revenue surpluses or deficits, DWSD must adhere to the provisions contained within the Rate Settlement Agreement and the Code of Federal Regulations. DWSD must generate sufficient revenue to pay the total operation and maintenance costs necessary to the proper operation and maintenance the sewage system. If a deficit occurs, DWSD must adjust the amount allocable to said user classes and subclasses.

DWSD has determined that a look-back adjustment is necessary for Detroit customers due to a deficit that occurred during the 2004-05 fiscal year. Pursuant to the Agreement and the Code provisions cited above, the deficit must be resolved. It is, however, unclear whether the entire amount of the adjustment must be captured during this upcoming fiscal year.

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<sup>1</sup> RAD does not have a copy of the auditor's report.